

**GAMCO**  
ASSET MANAGEMENT

# ENVIRONMENTAL, SOCIAL, GOVERNANCE ESG INVESTING

## **Why ESG Matters**

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## Executive Summary

One of the most significant developments occurring in investment management today involves the increasing integration of *Environmental, Social and Governance (ESG)* considerations into investing. Investors worldwide are becoming more aware of externalities and long term risks associated with climate change and other sustainability issues for all companies. They are examining these issues which have been under researched historically in order to understand whether and how they might affect companies, sectors and entire investment portfolios.

Questions to contemplate include: How and which companies will adapt to operate in a more resource constrained environment as the world population reaches 10 billion and natural resources continue to decline? Which companies are operating in a manner or developing products and services that will enable the world to grow more sustainably? What are risks if nothing changes? As the world collectively looks to limit and regulate the potentially damaging effects of climate change or social strains, which industries will be affected, which companies are evolving and which benefit?

The focus on such non-traditional information, both quantitative and qualitative, can be leveraged for more informed investment decision making. Unlike negative screening that has traditionally been associated with responsible investing, such ESG information is enhancing, forward looking and positively holistic. It offers a framework to answer such difficult questions. These exciting concepts are quite nuanced and have given rise to evolving research and data systems which enables investors to connect these risks into financial consideration, investment processes, new product strategies and, in fact, the entire investing ecosystem. While this area has dramatically grown over the last years, it is undoubtedly still in the early stages. Consequently, the significance of this fast developing area in investing cannot be ignored or underestimated.

This is *Why ESG Matters*.

## Introduction – Terminology from SRI to ESG

Investors' conversations in the US are accelerating around *Sustainable and Responsible Investing*. Since its development in the 1960's, responsible investing now covers investment approaches described as *Socially Responsible Investing*, *Environmental, Social & Governance (ESG) integration*, *Sustainable Investing* and *Impact Investing*. Collectively, there is estimated to be \$22.8 trillion invested globally in this umbrella category of responsible investment assets, according to Global Sustainable Investment Alliance. In the US, where responsible investing interest has historically lagged Europe, there is estimated to be \$8.72 trillion invested in the space at the end of 2016, according to the most recent report by the U.S. Sustainable Investment Forum (US SIF).

As more investors become educated on the topic and aware that they can achieve market based performance returns while limiting environmental or social harm to the world, there is determination that such long term investing mitigates a broader set of global risks. These risks include, but are not limited to: **climate change, water scarcity, waste production and social inequality**. Responsible investing aims to increase focus on corporate responsibility related to such issues because it views the private sector as critical to scaling solutions for these problems, rather than being solely focused on generating profits.

Within the umbrella term Responsible Investing, it is ***Environmental, Social and Governance (ESG) investing*** which refers to an investment framework that incorporates additional, non-traditional factors into investment analysis in a forward looking manner. It is viewed as a more holistic, positive way for investors to evaluate a company because ESG investing considers broader resource externalities as both risks and opportunities. It involves explicit examination of how a company manages certain finite resources and related risks material to its business operations - such as energy, water, other natural resources, human capital, diversity, ethics and aspects of governance. It also considers opportunities in alternative energy, services or products that reduce greenhouse gas emissions or other sustainable related areas. There are many ESG issues to be considered and the importance will vary by industry. Exhibit 1 details some examples of the types of issues that can affect a company's long term business sustainability which ultimately impacts long-term shareholder value.

**Exhibit 1**

 ENVIRONMENTAL	 SOCIAL	 GOVERNANCE
<ul style="list-style-type: none"><li>• Air &amp; Water Pollution</li><li>• Biodiversity</li><li>• Carbon Footprint</li><li>• Waste Management</li><li>• Water Scarcity</li><li>• Land Use</li></ul>	<ul style="list-style-type: none"><li>• Product Safety</li><li>• Employee Safety</li><li>• Labor Standards</li><li>• Supply Chain</li><li>• Diversity</li></ul>	<ul style="list-style-type: none"><li>• Board Independence</li><li>• Board Diversity</li><li>• Corruption</li><li>• Transparency</li><li>• Ethics</li></ul>

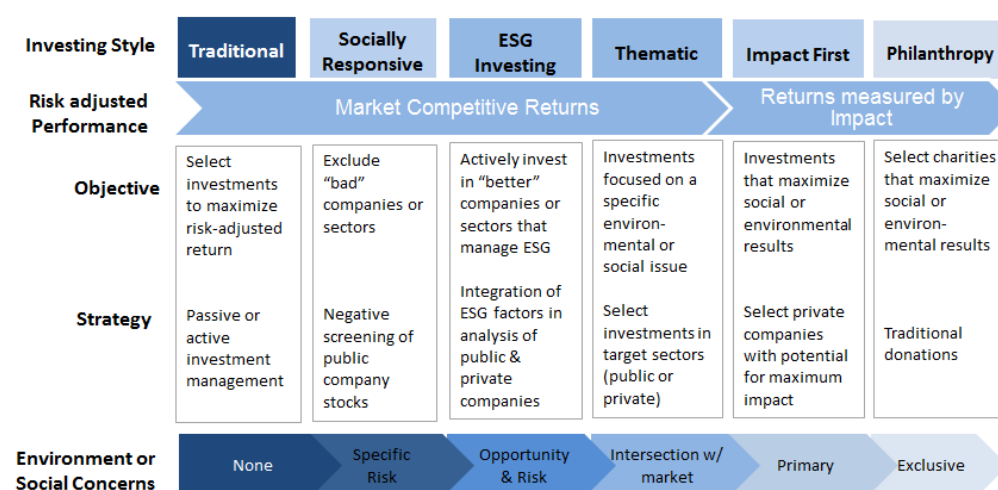
For many investors and some economists, it seems logical that a company should carefully examine resource use and monitor wasted resources in particular due to tangible costs to the company's bottom line. For others, responsible investing resonates because it enables them to align personal values on climate change or diversity through an investment framework. Ignoring such issues may lead to costs in the form of fines or reputation. Institutional investors and individual investors alike are increasingly embracing these concepts. They look to integrate ESG and responsible investing for risk mitigation, potential risk-adjusted outperformance and/or values alignment. They know that mobilizing private capital in this manner can further scale the focus on, and solutions to, some of the world's largest challenges.

Corporations are responding to investors' increasing sustainable focus. CEOs are now speaking about their sustainability initiatives, highlighting them as part of their strategy in some cases. Consumers and employees are considering companies not only for the sustainability of their products and services, but also for their corporate sustainability initiatives and business culture. Consequently, the range of possibility and customization for investors interested has evolved from the earliest forms of responsible investing from the 1960's. The difference within responsible investing styles is detailed in Exhibit 2.

Exhibit 2

## Responsible Investing

From traditional investing to philanthropy



### Categories Detailed

**Traditional** – investing where maximizing risk adjusted return is the sole consideration

**Socially Responsible Investing/ Negative Screening** – “the original SRI” excludes certain controversial companies (such as tobacco, alcohol, firearms stocks) or entire industries (gaming, fossil fuel related) to achieve a desired social mandate.

**ESG Integrated Investing** – the intentional analysis of certain environmental, social and governance factors. These non-financial issues are deemed to affect financial metrics and the long term sustainability of a company and its ability to increase shareholder value. Within ESG there is *ESG positive screening* seeking only “best in class” companies managing ESG risks and *ESG incorporation* - adjusting risk /return expectations for a company to account for specific ESG risks.

**Thematic** – investing in companies that connect to a specific environmental or social investing theme. Examples are investing in companies whose products or services target solutions to alternative energy, water scarcity, sustainable agriculture or educational development.

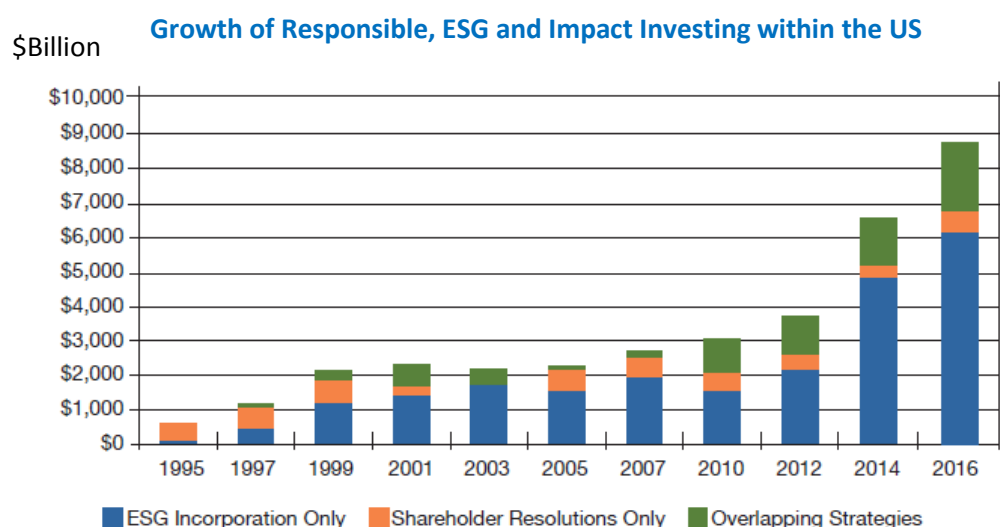
**Impact First Investing** – investing which prioritizes a very specific, non-financial environmental or social outcome equally alongside a financial objective. An example might be climate change bonds, microfinance, community reinvestment funds or a forest conservation fund. The impact can be measured and is prioritized.

**Philanthropy** – charitable donations toward specific social outcomes (i.e, lower poverty, social justice, improvement to wildlife, etc.). The “return on investment” in philanthropy is considered primarily to be any positive impact on the issue.

As some investors become more committed to influencing a company’s focus on sustainability, should they consider solving climate change or other large issues through investment portfolios? They may already be personally addressing these concerns through changing personal consumption choices, recycling habits, etc. But by and large, the investing field has been untapped. As ESG data and systems become more robust and education on ESG investing spreads, we believe ESG investing can take responsible investing to another level over the next decade. We are beginning to see accelerating growth, ahead of what may become widespread adoption in the US by institutional and individual investors.

Through the ongoing education of advisors, asset managers, academics and financial media, the field of responsible investing within the US has now reached \$8.72 trillion in 2016, according to US SIF shown in Exhibit 3.

**Exhibit 3**



US SIF identifies 477 institutional investors, 300 money managers and 1,043 community investing institutions that incorporate ESG issues into investment decision making.

A trend of new product launches, both active and passive across many asset class types supports the expanding responsible investing space. In 2001 there were reportedly just 181 products that incorporated some type of ESG risk factor and that was primarily governance according to US SIF. However by the end of 2016, there were over 1,000 products reportedly incorporating ESG factors and 2017 saw 39 new sustainable open-end funds and launched as firms planted flags in the responsible investing space. This is expected to continue given that investors are increasingly asking how ESG risks are considered in their portfolios. Noteworthy in 2016, many product launches were on the passive side, including a recently launched SPDR Gender Diversity ETF which was seeded by the institutional investor CALPers (California Pension Employees Retirement System). There have been ESG momentum products also created which aim to invest in companies that are systematically improving their ESG score by addressing their own internal sustainability issues. The difference in implementation varies significantly and many people think ESG lends itself better to active management, given the intentionality of the end investors. We anticipate new product launches and product transitions will continue.

Let's examine the investment rationale for the acceleration of ESG and responsible investing.

## **Why Sustainability and ESG Matter to Investment Performance**

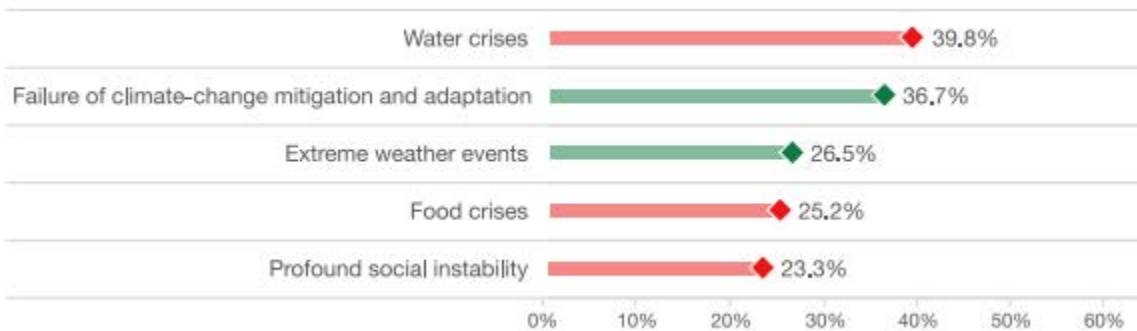
### **ESG as Risk Mitigation**

A fundamental tenant of active investing is looking at downside risk carefully. The effect of investment compounding gives downside periods an asymmetrical impact to investors' overall return performance over the long term. Consequently, anything that identifies and can mitigate downside risk is worth considering. In public equity, one way to understand and manage idiosyncratic stock level risk is through careful research. This entails understanding a business and an industry as an expert, to assess valuation, including understanding the drivers of management's capital allocation decisions, externalities of its operating environment along with its regulatory framework.

How does this connect to ESG investing? Fundamentally, awareness of ESG issues can enhance and broaden understanding of externalities and business operating sensitivity to increasing environmental and social risks. Stated simply, the world's population is growing from 7.5 billion currently, and is expected to reach 10 billion by 2050. The accompanying stress this puts on global natural resources and human capital equates to rising external risks to all companies and societies. To highlight this point, in 2016 the World Economic Forum published its 11<sup>th</sup> edition *The Global Risks Report 2016* which surveys and reflects the views of 750 experts – from business, academia, civil society, public sector professionals - across geographies. Among other things, the survey highlights a list of the perceived *Top Five Global Risks of Highest Concern for the next decade*. Notably in the 2016 report, four of the five perceived top long term global risks of highest concern were ESG related as detailed in Exhibit 4.

#### Exhibit 4

### Top 5 Perceived Global Risks of Highest Concern for Next 10 Years



Source: Global Risks Perception Survey 2015, World Economic Forum

The perception of these issues as significant global risks raises the question - *How will these risks affect an investment portfolio?* This is a reason why professional institutional investors more than ever before are trying to understand how these risks permeate through large portfolios. Moreover, which companies are taking necessary steps to manage their businesses around these inherent but growing, long term risks? Management of such risks requires measuring them and creating a mitigation plan. This, in turn, should increase the long term sustainability of a business as well as its ability to create shareholder value. Increasing disclosure around ESG issues by companies allows for more transparency. However, this disclosure varies widely and is not required in the U.S. Consequently, one of the current challenges is the inconsistent data availability and data variability for comparison. Over time, this should get resolved. But increasingly, ESG factors are becoming broadly accepted as materially significant.

Collective focus means that investors are putting greater weight on ESG factors to help understand which companies are mitigating these risks and examining how it connects to financial performance. ESG integration enables consideration of such non-financial issues and external risks in a way that negative screening and traditional investing simply does not. Yet due to the multitude of ESG issues, the importance of being able to connect a particular ESG issue into investment related analysis requires experienced judgment and perspective. Some specific examples of connections are listed in Exhibit 5:



## Exhibit 5

ESG related	Investment related
<ul style="list-style-type: none"> <li>• Water Quality</li> <li>• Water Scarcity</li> <li>• Water Management</li> </ul>	<ul style="list-style-type: none"> <li>• Production input cost</li> <li>• Manufacturing disruption</li> <li>• Impact on agriculture</li> <li>• Commodity price volatility</li> </ul>
<ul style="list-style-type: none"> <li>• GHG emissions</li> <li>• Energy efficiency &amp; management</li> <li>• Waste Management</li> </ul>	<ul style="list-style-type: none"> <li>• Production input cost</li> <li>• Increasing regulation</li> <li>• Increasing cost</li> <li>• Slower growth</li> </ul>
<ul style="list-style-type: none"> <li>• Food supply chain quality</li> <li>• Water availability</li> <li>• Farming Security</li> </ul>	<ul style="list-style-type: none"> <li>• Commodity price volatility</li> <li>• Global instability as population grows</li> <li>• Changing consumer choices</li> </ul>
<ul style="list-style-type: none"> <li>• Income inequality</li> <li>• Labor Practices &amp; Development</li> <li>• Employee Health &amp; Safety</li> <li>• Consumer Safety</li> <li>• Diversity</li> </ul>	<ul style="list-style-type: none"> <li>• Slower growth</li> <li>• Consumer behavior</li> <li>• Increasing regulation</li> <li>• Political instability</li> </ul>

Among ESG issues, we would highlight that the Governance aspect of ESG as perhaps the most developed historically. Corporate Governance has long been considered by the financial markets to be an important factor in understanding company management, both structure, oversight behavior and decision making. There are established “best practices” in governance.

The importance of “E” and “S” is increasing. While ESG issues and sustainability may not dramatically affect earnings from quarter to quarter, over the long-term they can have a significant impact on business performance. Additionally, responsible investors point to specific cases where some “ESG red flags” might have protected investors if an analyst had dug hard around certain issues – the **BP oil spill** was preceded by safety violations that exceeded industry peer groups; ESG analysis highlighted **Volkswagen’s** deteriorating governance practices. Consequently, the need for transparency around ESG issues cannot be underscored enough as it may, in fact, reveal types of risk not captured in traditional valuation modeling.

**Gabelli’s Magna Carta of Shareholder Rights** written in 1988 declared our stance on specific governance issues that we felt impacted shareholder value. Understanding a management’s track record of shareholder friendly capital allocation decisions has remained important to our research and analysis. Environmental and certain social issues of companies are additional risks that albeit historically ignored can provide insight into a management’s focus on resource efficiency, waste or even customer relationship management practices.

This possibility of protecting on the downside was the explicit focus of one study by Bank of America Merrill Lynch in December 2016. This study found that since 2008, investors who only held stocks of US companies with above average scores along Environmental and Social factors might have avoided 15 out of 17 bankruptcies. Furthermore, the highest quartile ESG scorecard companies were shown to have lower future price volatility than companies that scored poorly.

## ESG Adding Value

The debate around whether ESG considerations are alpha additive remains. Many academics, investors and large financial institutions have examined the relationship between ESG and investment performance closely. Unlike negative screening which reduces a potential investment universe compared to a benchmark, ESG integrated investing is additive, forward looking and does not rest upon negative screening. In 2015, Harvard Business School published its research “Corporate Sustainability: First Evidence on Materiality” by Khan, Mozaffar N., George Serafeim where they evidenced between 1993 to 2011 roughly 90 companies which manage material ESG issues and had strong sustainability policies (guided by SASB- Sustainability Accounting Standards Board framework) outperform a similar group of companies that had lower sustainability standards managing such issues. Also in 2015, an extensive meta-study combining the findings of 2,200 individual studies on the financial implications of ESG factors was performed by Deutsche Bank by Gunnar Friede, Timo Busch & Alexander Bassen. It identified that:

- approximately 90% of 2,200 studies find a non-negative relationship between ESG and corporate financial performance (i.e, suggesting performance is not sacrificed)
- the large majority of studies reported positive findings when risk adjusted returns are compared over long term horizons
- the positive ESG impact on corporate financial performance appeared stable over time. Results were even more pronounced in emerging markets.

In March 2015, Morgan Stanley found that sustainable mutual funds had equal or higher median returns and equal or lower volatility than traditional funds for 64% of the periods examined. In April 2017, research performed by Goldman Sachs’ Equity Research Department detailed in “the Portfolio Manager’s Guide to the ESG Revolution” further suggested that ESG integration can offer differentiated returns and an alpha-additive complement of risk analysis. These are just a few such research studies. ESG reporting and analysis will continue to evolve in the future, but is widely expected to play an increasingly important role to investors.

Research in the last several years has focused more on the ability to generate alpha if one focuses on identifying the signals captured by select ESG factors that are most directly linked and correlate to a company’s operations. This is termed “*materiality*.” The importance of materiality lies in separating material from immaterial ESG issues and is being proven to be critical to leveraging ESG information for investing. It relates more to ESG information as idiosyncratic risk. This is noteworthy to the development of responsible investing.

**Case New Holland Industrial (NYSE:CNHI) is a multinational manufacturer of agricultural and construction equipment established in 1999 through the merger of Case and New Holland.** In the company's 200+ page 2016 Sustainability Report, they highlight a *materiality analysis* designed to align ESG issues that shape and drive business decisions, as management increasingly integrates sustainability principles into the Company's daily business activities. CNH states that *"production processes are guided by principles which focus on continuous improvement and the elimination of waste and losses. This has led to great gains, \$112 million in savings through projects. The company adds that "materiality analysis has evolved into a strategic business tool."*

## Implications

Does the recent focus on ESG data, research, ratings and ranking systems mean that the decades old debate around whether negative screening causes underperformance will be slowly drowned out? Today's conversation is dominated by the more interesting idea whether understanding ESG factors can help contribute to alpha and by what amount? Investors have available to them many new sources of long term information that have largely been under researched. And as companies face complex, interconnected challenges which require an evolving approach to sustainability – some regulated, others from consumers - ESG issues play a meaningful role in creating long term value for stakeholders. Those who tap into this deep, under researched, non-financial information with the ability to connect it to the financial, *rather than simply ignore it*, may identify aspects of a company's strategic competitive edge. Understanding ESG factors and risks alongside traditional company analysis enhances understanding and should lead to better informed investment decisions which ultimately may generate better long term, risk adjusted performance.

In evidence of support for longer term thinking, in early 2016 several of the world's largest pension plans collaborated together to support the creation of the S&P Long-Term Value Creation (LTV) Global Index, which was designed to "measure companies that have the potential to create long-term value based on sustainability criteria and financial quality." The index combines a qualitative and quantitative metric which is intended to measure potential long term value addition. The qualitative assessment focuses on corporate governance and an Economic Dimension Score includes an assessment of risk, business ethics, supply chain, tax strategy and other criteria beyond even traditional ESG issues. It is designed to include elements which comprise drivers for sustainable business growth. The supporting institutional investors, representing over \$829 billion assets in aggregate, committed approximately \$2 billion to this index. Those investors included: Canada Pension Plan, Ontario Teachers' Pension Plan, GIC of Singapore, the ATP Group, New Zealand Superannuation Fund and PGGM. Most recently in July 2017, the Government Pension Investment Fund of Japan (GPIF), the largest pension system in the world, at roughly \$1.3 trillion assets, announced that it expects to raise its ESG allocation up to 10% of its portfolio through passive ESG strategies. Based on this plan sponsor's size, this would translate into \$29 billion into ESG related investments.

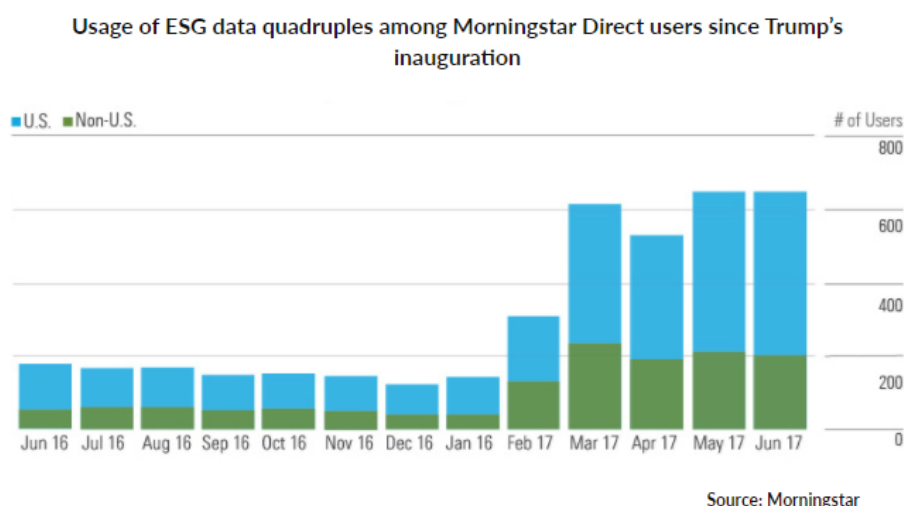
## ESG and Values Alignment

Amidst the conversation about ESG factors which help to identify, mitigate risks or contribute to outperformance, we cannot forget that the historical feature that has driven responsible investing for individual investors since the 1960's is the notion of *achieving closer personal value alignment around key, urgent issues*. As more individual investors become aware of the differences between ESG investing and negative screening, they are questioning their financial advisors and other professionals about this topic. The increasing transparency that companies provide around sustainability factors in their businesses permit investors to more confidently establish this as a goal. A number of wealth management surveys suggest that this is still largely client driven. Most advisors are still highly skeptical and are in early phases of educating themselves, let alone their clients. Consequently the dialogue between investors and their advisors is anticipated to expand much further.

Surely, one interesting aspect of the development of ESG investing is that all this is happening against the increasing focus on quarter to quarter earnings and monumental shift toward passive investing over the last decade. ESG investing seems to welcome back a balance of long-term thinking, corporate responsibility and ultimately, a degree of moral commitment from investors, whether they are institutional or individuals. Such commitment is required from both companies and investors to tackle the world's largest global challenges of climate change, water scarcity, preserving natural resources or social equality.

The sense of needed urgent action toward the environment is growing. In particular, the US Presidential election and recent withdrawal from the 2015 Paris Climate Accord appears to be galvanizing more investors toward ESG. Noteworthy, Morningstar, which had introduced a Sustainability Globe rating on over 20,000 mutual funds in early 2016 highlighted that investors searching for ESG fund data on Morningstar Direct *quadrupled in the months following the 2017 President Trump inauguration as shown in Exhibit 6*. This suggests that more investors and advisors are suddenly examining responsible investing strategies.

**Exhibit 6**



## **Fossil Fuel Divestment**

Related to value alignment is increasingly broad awareness and concern about climate change, which started the Fossil Fuel Divestment movement. It has grown since the COP21 meetings in Paris in 2015. At this 2015 meeting, a group focused on Fossil Fuel divestment, “350.org,” announced that investors with a combined \$3.4 trillion in assets — including pensions, foundations, family offices, cities, and individuals —pledged to divest, either partially or completely, from fossil fuels.

Fossil Fuel divestment groups are often propelled by activists, students or citizen organizations that desire endowments and pension plans to be aligned with sustainability. They view the world in a critical transition. They have aimed to pressure institutions to divest investment portfolios from fossil fuels and reinvest proceeds into low-carbon investment strategies, including those focused on clean energy and renewables. This effort may continue to be a tailwind for some ESG fund managers, clean tech firms and others.

The early leaders in the fossil fuel divestment campaign were: the Rockefeller Brothers Fund, Stanford University, the Church of England, CalPERs and CalSTRS. Overall, more than 612 institutional investors have so far committed to either partially or fully divesting from fossil fuels, according to GoFossilFree.org. Many endowments and other states such as New York are starting this same journey. Equally important is the growing number of institutional investors who are insisting on greater climate risk disclosure by companies as well as greater consideration by their investment managers. We note this gets mirrored in proxy voting trends. For example in May 2017, more than 50% of shareholders voted in favor of climate risk disclosure proxies at ExxonMobil and Occidental Petroleum. That was the first time such a threshold was reached.

## **Active vs. Passive in ESG**

Another notable dynamic within the world of responsible investing is the rapid development of passive strategies in the last years, alongside the shift generally to greater passive investing. Despite this seeming like a paradox to some historical responsible investors, passive ESG funds are growing significantly faster now than active strategies according to Morningstar. Since 2016 there have been 31 passive sustainable funds (indices and ETFs) launched in the US, aggregating nearly \$1 billion vs. 32 new active strategies totalling \$2.2 billion. This compares to ESG funds as a whole where active assets total over \$100 billion while passive funds hold \$13 billion. Passive strategies range from: fossil fuel free, best in class ESG rated companies; ESG optimized, improving ESG momentum scores and gender lens portfolios (portfolios comprised of companies with significant female leadership). With the development of external ESG research providers and ESG ratings services, many investors feel confident that that their investments will achieve greater sustainability by incorporating ESG factors passively. Should they?

Today, there are 17 recognized ESG research, ratings and rankings providers. When one examines the nature and quantity of unstructured information that crosses the ESG threshold, it becomes clear that investors and advisors should do their homework carefully. All investors

need to be aware that financial reporting is not integrated with ESG reporting today and particularly in the US, the current lack of data standardization, inconsistency and unverified ESG information presents serious challenges. Among experienced investors focused on ESG, it is commonly known that there is little overlap within ESG ratings, and between ESG rating providers of even the same company. This overlap is estimated at less than 50%. Additionally, large capitalization companies that have sustainability departments to generate robust corporate sustainability reports and interface with the ESG rating companies. This gives them a clear advantage over mid and small capitalization companies. Consequently, ESG strategies tend to have a large cap and growth bias in construction. Passive strategies must rely heavily on sound data and information integrated into a methodology. Are we there yet? ESG data must improve if it is to meet its potential in passive categories.

## **Proxy Power and Engagement**

True active investing emphasizes the importance of proxy voting and engagement by shareholders. Aside from divestment of certain industries and companies, the ability for investors to leverage proxy voting and shareholder engagement continues to offer meaningful ways to affect corporate behavior. Conscious decisions about whether and how engagement fits into an investment strategy are important. For socially responsible investors, engagement around environmental, social and governance issues are critical. Climate risk disclosure is a big issue and the overall trends relating to proxy voting and engagement on ESG issues appear to be increasing. According to research by E&Y and the Corporate Governance Intelligence Council:

- Roughly 66% of North American and European proxy voters supported a corporate sustainability shareholder proposal in 2016
- 54% of total proxy voters indicate they are spending more time scrutinizing corporate social responsibility practices than years prior
- In 2017 across four broad categories of shareholder proposals (governance and shareholder rights, environmental & social issues, executive compensation and corporate civic engagement) the most frequently submitted were Environmental & Social proposals, comprising 40% of the total.

Investors, often working together with civil organizations and multi stakeholders have raised the issue with numerous publicly traded companies to set GHG reduction targets, issue comprehensive sustainability reports, promote gender diversity on boards, report on political lobbying expenditures and set higher quality standards in global supply chains.

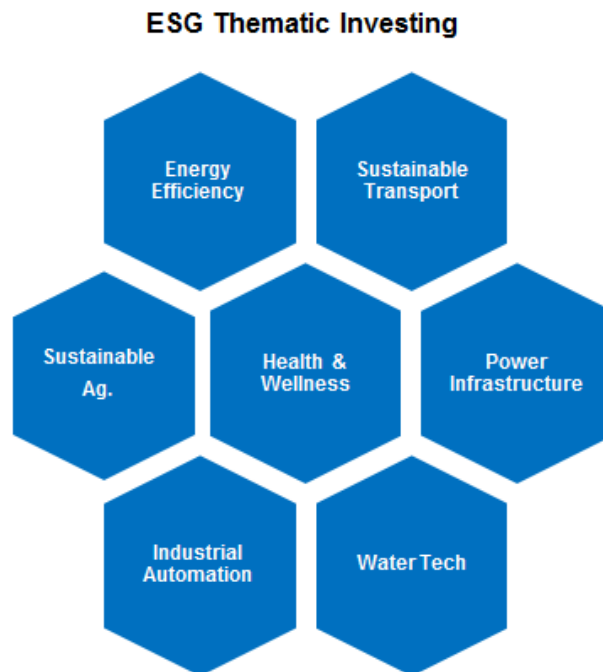
## **Looking Forward in ESG**

Since the 1960's a subset of investors have led the way in pushing for increased focus on issues related to corporate responsibility and sustainability. What once could primarily be expressed through exclusionary screening only evolved to include focus on renewable or alternative energy. The development of ESG integration has enabled a richer, more dynamic way of understanding more complex, interconnected risks related to sustainability. The issues

evolved as companies became willing to focus more on sustainability issues and disclose related information.

Evolution will continue to propel ESG and sustainable investing into the mainstream. With concern about climate change and global commitment to curbing it at most government and local levels, new opportunities and innovations develop each year. Investors are now discussing moving to “ESG 2.0” which will be defined by further commitment and advances in electric vehicles, sustainable infrastructure, industrial automation, sustainable agriculture and water technology, among other areas shown in Exhibit 7.

**Exhibit 7**



Just a few specific examples within sustainable transport/electric automotive include:

- China’s recent announcement that it will eventually abandon all sales of gasoline and diesel cars. They target 20% of all auto sales to be electric vehicles (EV) by 2025.
- UK and France pledge to make their auto markets fully electric by 2040.
- Potential related investment required to build charging and power infrastructure for full adoption of electric vehicles is estimated at \$6 trillion globally.

The resulting long term shifts will be dramatic. We see related innovations across this and many other areas offering a broad set of sustainable thematic investing opportunities over the next 20 years for investors.

## Gabelli's Approach in Responsible Investing and ESG

For over 30 years Gabelli Asset Management Company has been committed to responsible investing. It began in 1987 with our belief that investors can earn attractive returns by investing in portfolios that align more with their personal values. This is attributable to an investment philosophy rooted in fundamental, bottom-up research which seeks opportunities through the perspective of a business owner, rather than a short term stock trader. Our investment methodology utilizes a three pronged approach: free cash flow (earnings before interest, taxes, depreciation and amortization, or EBITDA, minus the capital expenditures needed to grow/maintain the business), earnings per share trends, and Private Market with a Value (PMV)<sup>TM</sup> with a Catalyst. We perform deep research on industries, demographic segments and long-term trends. With this long-term perspective, we do not let a generic market index drive our investment choices. The Gabelli research team seeks to identify attractive investment opportunities and themes, which are mispriced by the market. Our focus on selecting stocks for the long term, to construct portfolios with typically high active share relative to a benchmark, leads to lower turnover and resists overemphasizing the short term. It dovetails with the longer term nature of ESG issues.

Importantly, there are a range of methods available to investors to incorporate ESG issues into an investment strategy. We believe the judgement used to assess impact on valuation is important. For example - Is a company's good (or poor) ESG record in carbon emissions, product quality or labor relations material to its business? Does it significantly affect costs and possibly improve (or impair) earnings power into the future? Does a company which is better at integrating ESG and sustainability derive a competitive advantage from it? Is this reflected in higher growth, higher margins or lower capital costs? Should an ESG portfolio own more or less of such a company? Are there significant sustainability related trends in particular industries (i.e, automotives, food) and how might that change industry dynamics into the future?

Gabelli's approach in its ESG focused portfolios has evolved as responsible investing has evolved with more transparency from companies. Exhibit 8 shows its three main areas:

Exhibit 8





Some examples worth highlighting:

**Johnson Controls Inc. (JCI)** merged with Tyco early in 2016. The company is a multinational provider of HVAC security and fire safety systems for global commercial and residential customers. The company is also the world's largest automotive battery manufacturer. Using the Sustainability Accounting Standards Board (SASB) framework which guides investors on material ESG issues by industry, one can begin to understand which ESG issues are material to JCI's business. These primarily include: toxic and emission waste produced in manufacturing, the health and safety of their workers, and the product opportunity they have in batteries, energy storage solutions and HVAC systems to create increased energy efficient solutions. Investors then need to consider if JCI measures these material ESG issues and has resource reduction targets that translate into less waste produced. What are their solutions? How have they done?

Five years ago JCI management set clear emissions reduction targets and over this time, Johnson Controls Inc. has:

- reduced energy intensity used per unit produced by over 20%.
- achieved 41% reduction in their greenhouse gas emission intensity.
- pioneered and advanced the use of the stop-start battery which automatically shuts off when a car is idling. This saves 660 million gallons of fuel and reduces green house gasses by 6 million metric tons per year, according to JCI.
- achieved battery production with over 80% recycled content.
- become the world's largest recycler of lead as they reacquire and resmelt lead from expired auto batteries

We can assess that JCI is managing its own resources carefully, reducing waste output from production while enabling customers to become more sustainable through their energy savings solution products. We next think about how this impacts JCI's valuation. Should they benefit from a lower cost of capital or does this warrant a more stable or better multiple relative to competitors?

**Danone (BN)** is a global food company with four main businesses: dairy, water, early nutrition and medical nutrition. Their company mission centers around health through food. Their fresh dairy strategy includes focus on the nutritional benefits of yogurt for digestion and in 2017 they acquired White Wave foods, a maker of plant based non-dairy products such as almond milk, and coconut milk products. They also bought a majority stake in Happy Family, an organic baby food company, in 2013. These strategic acquisitions are designed to shift their product portfolio further toward healthy eating, where growth rates are above food industry averages. This is due to consumers' concern over processed foods. Danone highlights that "food produced more sustainably can protect and restore the planet."

Using the Sustainability Accounting Standards Board (SASB) framework which guides investors on material ESG issues by industry, one can begin to understand which ESG issues are material to Danone. The material ESG issues include: energy use, fuel, water, product safety & quality, fair marketing, material sourcing and related supply chains. Danone has:

- a zero net carbon target and since 2007 has reduced their CO<sup>2</sup> intensity by 50%.

- they have worked with farmers and other supply chain partners to help advise and train them for improvements to enhance farming sustainability practices.
- addressed water scarcity which is critical to their bottled water business, used to raise dairy cows in supply chains and used to grow almonds for almond milk. Consequently, managing water quality and risk to its availability is important to business. Danone has a goal to reduce water use in its factories by 60% by 2020 (from 2000 baseline).
- moved to 100% recyclable packaging

Again, we can assess that Danone is proactively addressing the risk to natural resources they need in their business operations, thereby increasing the sustainability of production and their business long term. This results in a higher quality manufacturing process and customer relationship. Danone's valuation should reflect this lower risk and long term higher quality. Does this warrant a more stable or better multiple relative to competitors?

## Sustainability Themes

### Water

Long term investment opportunities related to sustainability persist on a global scale in many areas. We identified the *Water Scarcity* theme many years ago after examining the long term secular trend which drives water demand far beyond water supply as the global population increases to 9 billion by 2030. Our research around understanding the long term strain on water related infrastructure and the fragmented nature of the industry enabled our team to identify many companies whose businesses benefit from helping to solve this long term global challenge. We identified companies involved in the delivery, treatment and development of water saving technology, and whose Private Market Value™, according to our methodology, was mispriced. Once identified, we could then confidently invest in these companies to get exposure to the investing opportunity of the Water Scarcity theme for the long term.

Related to this, aside from infrastructure, the severe drought in the western region of the U.S. through 2016 has brought more focus on the water demand footprint of Americans. The average American family uses more than 300 gallons of water per day at home. But also of interest is the average American diet which requires more than 1,000 gallons of water a day to produce related food and beverages consumed. Consider some examples:

Edible Item	Water Required to Produce
1 pound of chicken	468 gallons
1 cup of milk	55 gallons
1 apple	18 gallons
1 slice of bread	11 gallons
1 head of broccoli	5.4 gallons
1 almond	1.1 gallons

Source: National Geographic

While U.S. consumers today generally do not consider such issues, all food companies need to consider water scarcity risk as it affects their own product manufacturing. And like our earlier example of Danone, companies are able to improve management around such issues.

## **Health & Wellness**

Another sustainability related theme that we researched many years ago was around *Health and Wellness*. The US obesity rate is now among the highest in the world, at 36.5% of the US population, which represents an 88% increase from 1997 to 2014, according to the Centers for Disease Control & Prevention. This has significant implications on medical costs, worker productivity and society as a whole. As more information and education has surfaced around how diets influence obesity, food consumption patterns in the U.S. have begun to change. The shift to natural, healthy and organic foods has advantaged certain types of companies and products. Our early research around this trend enabled long term investments in companies that were positioned or those that were shifting to address this social health issue. It also helped to identify possible strategic acquisitions within the food industry, again leaning on our Private Market Value™ investment process to guide our focus to find those companies suitably mispriced in the market.

These are just two examples of sustainability related themes. There are many others and the future will undoubtedly present more.

## **Exclusionary**

Historically, exclusionary screening drove responsible investing and centered around the avoidance of sin stocks or certain industries (no alcohol, no tobacco, no weapons, etc.). It is relatively easy to implement and can be customized to the client. Today because there are increased disclosure by companies and fairly robust, dedicated ESG research services, it is possible to implement a more nuanced set of exclusionary screens. We have seen this aspect of responsible investing broaden as investors' choices expand. There are screens around nuclear & cluster munitions, fossil fuel reserves, animal welfare, human rights violations, child labor, lending controversies, stem cell research and various global sanctions. We encourage investors to think about performance implications carefully whenever considering extensive exclusionary screening.

For our own responsible investing strategy, we look to address some of the most controversial issues with historical screens around alcohol, tobacco, gaming and weapons/defense producers. Historically due to our lower exposure to commodity driven investments, we have recently incorporated screens on fossil fuels upon request. Our ability to further customize additional exclusionary screening in certain types of private portfolios is a key attribute in the area of responsible investing.

## **Engagement**

Engagement with management has been a hallmark of Gabelli Asset Management Co. We historically have voted our own proxies. Since the 1980's, following the creation of our "Magna Carta of Shareholder Rights" in 1988 we have been considered a leading voice among active investors, looking out for shareholders. As security analysts, we look to make informed decisions on all matters that will affect the economic value of investments. We have been

involved in many governance efforts including shareholder proposals to remove of poison pills and nominate Director placements, among many others.

### **Our Responsibility**

Today, companies have a unique set of Environmental, Social and Governance challenges in a world where resources are diminishing due to population growth. This externality along with changing consumer preferences across industries presents both investing challenges and opportunities. As long term investors, we need to understand the ESG issues that affect the companies in which we invest.

## Appendix – ESG Ecosystems

A significant factor that has helped fuel growth of responsible investing has been the rapid development of data availability on ESG factors. While there continue to be gaps and inconsistencies across companies' disclosure of related ESG data, companies have come a long way. According to the Governance and Accountability Institute, today over 80% of the S&P 500 companies disclose some form of ESG data, up from just 20% in 2011. However because of regulation differences around the world, there remain notable inconsistencies. For example, in Europe companies are required to disclose climate and GHG emissions related data on business operations while in the U.S. this is not a requirement by US regulators. While there are reported to be over 100 organizations analyzing and collecting ESG information about companies, we identify several key players in Exhibit 10 who have been critical to the development of the evolving ecosystem for ESG integration and responsible investing.

Exhibit 10



**CDP** (formerly known as the Carbon Disclosure Project) – For over 15 years, CDP has been the largest repository of climate data which exists in the world. This organization has worked with both companies and shareholders to encourage and push for the disclosure and consistent standards of disclosure of greenhouse gas data. In 2015, over 3000 companies voluntarily reported their climate change data to CDP. In 2014 CDP began an effort to collect similar data on water.

**SASB** – Sustainability Accounting Standards Board was started in 2011 with the goal to create sustainability focused accounting standards, similar to FASB (Financial Accounting Standards Board). SASB focuses on defining ESG factors that are “material” to a company’s operations and aims to integrate its standards into the Form 10-K which are required to be filed by the US SEC for public companies. SASB is noted for its “materiality map” that identifies the most material ESG issues by industry and compares disclosure topics across for nearly 80 industries.

**PRI** – Principles of Responsible Investing (formerly UN PRI) is a network of international investors committed to working together to increase understanding of and focus on sustainability issues for investors. They commit to incorporate these into investment decision

making and ownership practices. Collectively the 1,600 signatories represent US \$62 trillion AUM (November 2016).

**Sustainalytics** – As the historical leader in ESG research on companies for over 20 years, Sustainalytics has 170 ESG research professionals using a weighted ESG rating system on over 6,000 companies that is numerical (1 to 100 for bad to best, respectively).

**MSCI ESG Manager** - launched in 2011 with now over 250 ESG research analysts covering 6,500 companies, 11,000 fixed income issuers. ESG factors are examined within industries and companies' ESG ratings are AAA (highest) to CCC (lowest). Additionally they are able to analyze a portfolio's carbon footprint which is ever more important to responsible investors. MSCI now boasts that it tracks more than 700 Environment, Social and Governance (ESG) issues. Recently MSCI ESG Fund Metrics launched ratings on 21,000 funds assigning portfolio ESG scores indicating how holdings manage medium to long term ESG risks.

**Bloomberg** – For ESG data, Bloomberg terminals now deliver ESG metrics on companies and have partnered with several organizations including Sustainalytics to make ESG data and information more readily available to investors. Bloomberg itself assigns companies ESG disclosure scores.

**Morningstar** - While well known for their mutual fund star ratings, in early 2016 Morningstar launched a "Sustainability Globe rating system," partnering with Sustainalytics to rate 20,000+ mutual fund portfolios worldwide. The ratings are intended to provide a consistent way for fund investors to understand the sustainability sensitivity of the fund portfolios in which they invest.

There are many other excellent ESG research providers which could not all be listed here. We believe that the growth and commitment of these research companies, data systems and organizations translates into the ability to have such ESG information and risks more broadly considered.

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Christina Alfandary is Managing Director, ESG and Sustainable Investments at GAMCO Asset Management. Since 1987 GAMCO has worked with Socially Responsible Investors to meet their values based investing objectives. At GAMCO, Ms. Alfandary oversees the company's expansion of its ESG integration efforts and ESG investing capabilities. Ms. Alfandary has appeared on television and radio, spoken at numerous conferences helping investors and advisors understand and incorporate ESG and impact investing into portfolios. Ms. Alfandary has over twenty-five years of experience in the investment industry.

Prior to re-joining GAMCO, she served as Senior Managing Director, Co-Head of Nikko Asset Management Americas, Inc. until 2015. Among her many responsibilities overseeing the US business, she was instrumental in a US product launch for a green bond product developed in collaboration with the World Bank. Prior to Nikko AM, she was a Vice President at GAMCO Investors from 2000 to 2005 where she worked with institutional and high net worth clients. Her prior experience includes working at Morgan Stanley.

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As of December 31, 2017, GAMCO and its affiliates own 1.18% of Case New Holland, less than 1% of Johnson Controls, Inc. and less than 1% of Danone.

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